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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR., AND ROXANA CATTO

UNITED STATES OF AMERICA, PETITIONER

v.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

I

All parties agree that the basic question here is whether or not an accrual method rancher can properly be required to defer (*i.e.*, capitalize) the costs of raising breeding animals and deduct such accumulated costs against the proceeds derived from their

sale.[1] See, *e.g.*, *Wardlaw* br., p. 43. Respondents argue that they need not accumulate the costs of raising breeders because Code § 1231 forbids it.[2] In enacting that section, they assert, Congress meant to give accrual method ranchers capital gain treatment on the full proceeds received from sales of breeding animals. To the contrary, § 1231 grants capital gain treatment only to the "gains" recognized on sales of breeding livestock, and the word "gain" typically means the excess of sales proceeds over the accumulated cost (or other basis) of an asset rather than the full sales proceeds. See, *e.g.*, 1954 Code §§ 1001(a), 1012. Taxpayers have always been required to accumulate, until the time of sale, the costs of production. This is so whether they are on the cash or accrual method, whether the products are included in inventory (1954 Code §§ 471, 1013; Treas. Regs. § 1.471–1) or are capital assets (1954 Code §§ 263, 1016(a)(1); Treas. Regs. § 1.263(a)).[3] Indeed, the Regulations dealing specifically with ranchers and farmers (promulgated in the early 1920's and carried forward to the present substantially verbatim) have always required accrual method ranchers to accumulate the costs of raising livestock.

In the early 1920's the Commissioner recognized that many farmers and ranchers were not capable of

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[1] This question applies equally to all accrual method ranchers, regardless of whether they are on the unit-livestock-price method, the farm-price method, or some other variant of the accrual method of accounting, and regardless of whether or not they have chosen to include breeding animals in inventory.

[2] All citations to the Code or Treasury Regulations refer, unless otherwise stated, to the Internal Revenue Code of 1954 and the Regulations promulgated thereunder.

[3] See also, *e.g.*, I.T. 1309, I–1 Cum. Bull. 196 (1922).

valuing cattle on hand and deferring costs properly allocable to them. Therefore, in order to afford them an extremely simple method of accounting, the Commissioner relaxed the general rule requiring all taxpayers to accumulate the costs of constructing or creating assets. Pursuant to his authority to promulgate and define methods of accounting,[4] he permitted farmers and ranchers who elected the *cash* method to deduct the costs of raising crops or livestock as incurred.[5] However, it is quite clear that as to those farmers and ranchers who elected the *accrual* method of accounting, the Regulations did not deviate from the general rule requiring all taxpayers to defer the costs of constructing or creating either inventory or capital assets. Indeed, to have done so would have upset the accrual method as a more accurate alternative to the simplified cash system.

As is frequently the case in the Income Tax Regulations the Commissioner did not enunciate in one place all of the rules governing the two methods of farm and ranch accounting. In part the rules are set forth in the portion of the Regulations dealing with income;[6] the remainder appear among the Regulations dealing with deductions.[7] Although both sets of rules were obviously meant to be read together, respondents persist in citing only that portion concerned with deductions and ignore the one dealing

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[4] See, *e.g.*, 1954 Code §§ 446, 471, 7805, and their predecessors.

[5] Regulations 65, Arts. 38, 111 (1924 Revenue Act); 1954 Treas. Regs. §§ 1.61–4, 1.162–12.

[6] Regulations 65, Art. 38 (1924 Revenue Act); 1954 Treas. Regs. § 1.61–4.

[7] Regulations 65, Art. 111 (1924 Revenue Act); 1954 Treas. Regs. § 1.162–12.

with income. The Regulations provide a two-step procedure: First, the part dealing with deductions provides that, in general, "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions." Second, the Regulation dealing with the computation of income provides (a) that a *cash* method rancher need make no adjustment on account of costs incurred in raising livestock which are still on hand at the year end (*i.e.*, that the *cash* method rancher need not reduce the deduction allowed by the first Regulation discussed above), and (b) that an *accrual* method rancher, on the other hand, must add to income the amount of the increase in the raising costs attributable to such animals still on hand (*i.e.*, he must reduce the deduction allowed by the first Regulation discussed above by this amount).

The reason that accrual method ranchers are first given a deduction for raising costs and are then required, in effect, to offset the deduction by adding to income the increase in the cost (or estimated cost) of their livestock on hand is because this two-step procedure automatically performs the difficult task of allocating the various ranch and farm expenses (such as feed, labor, etc.). See our initial brief, pp. 11, 26–30. The parties agree that the net effect of these Regulations is properly to require accrual method ranchers to accumulate the costs of raising their *inventory* animals. See, *e.g.*, Stipulation of Facts, R. 67–70, 3–5. At the time these Regulations were originally promulgated, accrual ranchers included their

breeding animals in inventory for accounting convenience. Therefore, the Regulations provide that, if an accrual method rancher wishes, he may consistently include his breeding livestock in inventory, but that, if he does not elect to do so, they shall be "treated as capital assets subject to depreciation." Regulations 65, Art. 38 (1924 Revenue Act); 1954 Treas. Regs. § 1.61–4(b). If an accrual rancher elects to keep his breeders in inventory, he is thus required to offset that part of the "deduction" for raising costs attributable to such animals on hand at year-end. If, on the other hand, he elects to treat them as "capital assets" he is subject to the general rule requiring accumulation of the costs of creating or constructing a capital asset (see *supra,* p. 2), in which case he must similarly offset that portion of the "deduction" for raising costs attributable to increases in the estimated cost basis of breeders on hand.[8]

[8] At numerous places in their briefs respondents make statements to the effect that the Commissioner's position would require them to recognize part of the increase in value of breeders as ordinary income each year. See, *e.g.*, *Wardlaw* br., pp. 5, 13, 20; *Catto* br., pp. 3–4. As respondents readily recognize at other places in their briefs, the Commissioner's position in the instant cases does not in fact create any ordinary income on account of breeders; viewing both the income and the deduction portions of the Regulations together, their net effect is merely to create and then offset the accrual ranchers' deduction for the costs of raising breeders, and thus to defer the raising costs until the animals are sold, at which time the accumulated costs are deducted against the sales proceeds in computing gain. See, *e.g.*, *Wardlaw* br., pp. 6, 9, 20–22, 29, 34–35, 42–43.

Respondents concede that accrual ranchers must accumulate costs incurred in raising beef (inventory) animals. Stipulation of facts, R. 67–70, 3–5. They nevertheless argue that accrual ranchers are not required to accumulate the same type of raising costs when incurred in connection with breeding animals. But the Code provides that "No deduction shall be allowed for * * * [a]ny amount paid out * * * to increase the value of any property" (1954 Code § 263), and that such expenditures shall instead be added to the cost basis of the property (1954 Code § 1016(a)) and deducted against the proceeds received upon sale of the property in order to compute gain or loss (1954 Code §§ 1001(a), 1012). The Regulations make it clear that a taxpayer must capitalize the costs of producing or constructing "machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year." Treas. Regs. § 1.263(a)–2. The costs of raising a breeding animal from birth to maturity (when it is put in service) are, for this purpose, equivalent to the costs of constructing a piece of machinery or equipment.[9] Respondents are thus re-

[9] Respondents argue that since the expenses of feeding and caring for *mature* breeding animals are deductible as incurred, the same type of expenses when incurred in raising immature breeders must also be deductible. However, it is clear that certain costs must be capitalized when incurred in constructing a machine (such as for small parts and lubricants), while similar costs incurred in regularly maintaining the machine after it has gone into service are currently deductible. See Treas. Regs. § 1.162–4.

Respondents also argue that the fact that *cash* method ranchers are permitted to deduct the costs of raising breeders

quired to defer, until sale, the costs of raising breeding animals, regardless of whether they choose to include their breeders in inventory or treat them as "capital assets."[10] Treas. Regs. § 1.61–4(b). The principal difference between including breeders in inventory and treating them as "capital assets" is merely one of accounting mechanics, since both achieve the same result.[11]

Moreover, the Regulation defining the unit-livestock-price method of valuing livestock, promulgated

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prove that such raising costs are not the type of expenditures that § 263 would require a taxpayer to capitalize. However, as explained *supra*, p. 3, the Regulations, in order to create a special simplified method of accounting for farmers and ranchers, have deviated from the usual capitalization requirement with regard to raising costs incurred by *cash* method farmers and ranchers.

[10] Certainly the Regulation does not, as respondents suggest (*Wardlaw* br., p. 34, fn. 48), require an accrual method rancher to accumulate the costs of raising breeders if he elects to include them in inventory, but not if he chooses to treat them as "capital assets." Such a rule would not effectuate the Commissioner's manifest purpose in promulgating the Regulations here in question, that is, to create a simplified cash method of accounting for ranchers and farmers who wish to deduct the costs of raising their crops and livestock as incurred and a more accurate method for ranchers who were both willing and able to maintain sufficient records to accumulate the costs of raising their animals and match such costs against the income they produce.

[11] Contrary to respondents assertion (*Wardlaw* br., p. 39, fn. 52), there is no stipulation that the Commissioner would not permit ranchers to remove their raised breeders from inventory. However, even if respondents had asked for and obtained such permission, they would nevertheless have been required to accumulate the costs of raising breeding animals. Respondents admit that this would be the result if the Commissioner's position in the instant case prevails. *Wardlaw* br., pp. 42–43.

in 1944, confirms the conclusion that the 1924 Regulations required all accrual method ranchers to accumulate the costs of raising breeders. It provides that any rancher who has elected the unit-livestock-price method of valuation "must apply it to all livestock raised, whether for sale or for * * * breeding * * * purposes" (Treas. Regs. § 1.471–6(f), *i.e.*, he must use this estimated-cost method to value both his beef and his breeding animals, irrespective of whether, for accounting convenience, he has elected to include his breeders in inventory.[12]

When Congress in 1951 amended the predecessor to § 1231 of the 1954 Code to explicitly provide that "gains" from sales of breeders would be taxed as capital gain, it had before it all of the above mentioned Regulations as well as a published revenue ruling making clear that in computing the amount of "gain" from the sale of breeders an accrual method rancher would, pursuant to the usual rules for computing gains, deduct his accumulated costs of raising

[12] These Regulations also provide that after *purchasing* an immature breeding animal, the taxpayer must increase the animal's cost basis each year until maturity by the amount of his estimated costs incurred in raising the animal that year (according to his established yearly cost estimates). Treas. Regs. § 1.471–6(g). It is clear from the immediately preceding sentence of the Regulations that this rule is meant to apply regardless of whether the taxpayer has elected to include his purchased breeders in inventory, and that this rule requiring ranchers to accumulate the costs of raising immature *purchased* breeders is merely illustrative of the requirement that accrual method ranchers must accumulate the costs of raising all immature breeders, whether purchased or born on the ranch.

the animal, whereas a cash method rancher would (because of his simplified method of accounting) have no accumulated cost basis to deduct.[13] As discussed in detail in our initial brief, the Committee Reports accompanying the 1951 statutory amendment demonstrate that Congress recognized that accrual method ranchers would continue to deduct their accumulated raising costs in computing "gain."[14] Shortly thereafter Congress rejected a proposed amendment to the Code which would have altered the accrual ranchers method of computing gains and instead reenacted § 1231 verbatim in the 1954 Code.[15]

II

Respondents argue that they never elected the unit-livestock-price method, but that it was forced on them in 1944. This does not comport with the facts. We have shown that before 1944 the Regulations required accrual method ranchers to accumulate the cost of raising breeders. Most ranchers, including respondents, consistently used an estimated cost method known as the constant-unit or unit-price method to accomplish this result. In 1944 the Commissioner promulgated a Regulation formally recognizing that method of valuation (T.D. 5423, 1945 Cum. Bull. 70), and requiring those ranchers who, like respondents, had already begun using it to continue the practice. See Treas. Regs. § 1.471–6(h)

[13] See I.T. 3666, 1944 Cum. Bull. 270, discussed at pp. 14, 22 of our initial brief.

[14] See our initial brief, pp. 14–15, 22–23.

[15] *Id.*, p. 15.

and its 1939 Code predecessor, Treas. Regs. 111, § 29.22(c)–6. Inasmuch as all taxpayers who adopt a particular method of accounting for an item of income or expense, including inventory, must continue to report that item consistently unless the Commissioner grants permission to change (*Brown* v. *Helvering,* 291 U.S. 193; 1954 Code § 446(e); Treas. Regs. §§ 1.446–1(c)(2)(ii), (e)(2)(i), (e)(2)(ii), 1.471–2(b), (d), 1.471–6(a)), the 1944 Regulation required no more of respondents than they were already bound to do. Furthermore, the Commissioner has granted permission to switch from the unit-livestock-price method to other variants of accrual accounting, but respondents have never requested permission to change, undoubtedly because the unit-livestock-price method of livestock valuation is the most favorable method for taxpayers.[16]

III

Finally, respondents argue that even if accrual method ranchers have always been required to defer

[16] A rancher on the unit-livestock-price method defers an estimated amount of raising expenses which, as a matter of practice, is generally less than actual raising costs, and therefore he usually does deduct part of his raising costs as incurred. The farm-price method, which is the second most popular method of valuation, requires the farmer or rancher to value his crop or livestock "at market price less direct cost of disposition." Treas. Regs. § 1.471-6(d). Since this value would generally exceed the taxpayer's cost of raising the items, it would prevent him from currently deducting any of his raising costs and might result in some anticipation of income. The other available inventory methods, cost and the lower-of-cost-or-market, would also generally result in the taxpayer's deferring his full raising costs.

the costs of raising breeders, they should nevertheless be excused from this requirement because they had no "meaningful choice." Respondents evidently mean that at the time they chose between the simplified cash and the more accurate accrual methods of accounting, they did not know that the "gains" from sales of breeding animals would, after 1942, be taxable as capital gain rather than as ordinary income.

The short answer is that respondents may not revoke their election merely because a change in the law has altered the relative tax advantages of one method over another. "Tax statutes and tax regulations never have been static. Experience, changing needs, changing philosophies inevitably produce constant change in each. One making an election in [a previous] * * * return [takes] * * * the risk that the method of treatment of [an item] * * * might be changed by Congress, or, where power existed, by the Commissioner." *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 97 (where the Court rejected taxpayer's argument that a change in the law after it had elected between two methods of accounting invalidated the Regulations because it "had no free choice").[17] Similarly,

[17] See also *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, where the taxpayer in 1937 elected to report his gains from sales of land on the installment method of accounting. Thereafter (in 1940) Congress enacted an excess profits tax which, in general, applied only to a taxpayer's income in excess of 8% of his "invested capital." The Commissioner ruled that taxpayers on the installment method of accounting could not include their unrealized gains from past sales in their "invested capital," although those on different methods of accounting could. The Court upheld the validity of the regulations.

in the instant case, respondents, having elected the accrual method of accounting, "took the risk that the method of [taxing gain on the sale of breeding animals] * * * might be changed by Congress." [18]

Respectfully submitted.

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[18] Even assuming that there is merit to respondents' claim that they were denied a "meaningful choice," the only remedy to which they could be entitled is a new election, *i.e.*, an opportunity to make a "meaningful choice" between the cash and accrual systems of accounting. However, the respondents admit that "They are not seeking to switch to the cash method of accounting." *Wardlaw* br., p. 42. Respondents are attempting to use a hybrid method of accounting never authorized by the Commissioner, under which they could combine the advantages of the cash and accrual methods of accounting. This they may not do. See *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 503–504; see also cases cited at p. 24 of our initial brief.

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